18 October 2014

Woodhall's Weekly

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Can I hear the fat lady singing?

- **A bounce back is underway**
- **Data were mixed**
- **Our forecasts are strengthening**

Overview

After a miserable Monday, our market had four positive days and the SPI futures are up +68 points for every chance of a magic Monday start to next week.

Materials (+2.3%) and Financials (+2.0%) led the charge for the ASX 200 to finish the week up +1.6%. The massive finish to the week on Wall Street could not save the S&P 500 finish -1.0% down on the week.

There were some wild sessions during the week – particularly mid-week on Wall Street. The VIX spiked at 31.1% but closed the week 10% points lower.

Our intra-day low was 5,122 but our closing low was 5,156 – just six points off our forecast (closing) low for the year of 5,150!

There was lots of news around last week. China stormed across the line with great import and export data. Germany revised its forecast for 2014 growth down to +1.2%. US retail sales missed but reporting season in the US got off to a good start.

All of the geopolitical remained unresolved but it was Ebola that grabbed the market's attention. When the second case on US soil was reported at 6am New York time on Wednesday, the market sell-off was savage.

The real positives for the week seem to have been the 'Beige Book' release that 11 of the 12 US regions had modest to moderate growth forecasts (as normal) and Bullard – a Fed member – came out and said QE tapering might slow down. Yellen too spoke positively for markets.

So with Fed-speak calming nerves, the stellar Q3 reports from Morgan Stanley and General Electric gave Wall Street a very strong finish to the week.

Oil prices rebounded slightly and iron ore prices got as high as $84. With a correction seemingly behind us and our markets' fair price estimated to be 5,600, our improved forecast for capital gains makes 5,700 or more achievable by the end of 2014.

Since both the ASX 200 and the S&P 500 hit our respective low forecasts for the financial year on the same day – and our fear index nearly got back to the normal range – I bought a 50:50 parcel of ETFs (IOZ and IVV) for the ASX 200 and S&P 500) for my geared portfolio last Thursday.

I sold Woodside at the end of June 2014 for around $41.50 since I needed to sell something to pay for my new yield portfolio I was constructing. Woodside's consensus recommendation moved to an unacceptable 3.5 score making it a prime candidate for sale. So with a forecast yield as good as the banks, and the consensus rec jumping back to 3.1, I bought back in at under $40 for my SMSF yield portfolio yesterday (which is slightly cheaper

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after taking the missed dividend into account – but this was a rec play and not trading!). I used my dividend cheques and Telstra buy-back proceeds to fund the purchase.

In June, when I bought my yield portfolio, my construction method wanted to put money to work in the Energy sector but no stocks then passed the filter to get a gig. Now Energy is represented!

Market expectations

We started the year with our 2014 ASX forecasts for e-o-y at 5,850; a low of 5,150; and a high of 6,150.

Last week I wrote "If the SPI futures for Monday's open of -38 points comes through for the ASX 200 we will hit our low target almost spot on! Will the market bounce off it! It might just." Well it has and it might just well stick unless a bigger Ebola outbreak happens.

Underpricing has been slightly eroded from -7.5% last week to -5.9% this week. The good news is our 12-month capital gains forecast has climbed further from +7.7% last week to 8.7% this week on a strengthening Financials sector. Our gains' forecast is now the highest it has been for 2014!

We have fair value for our index of 5,600 so a rapid return to that level and then growth at +8.7% pa could easily take us above 5,700 for New Year's Eve. However, there are far too many major geopolitical and economic issues on the boil to be too optimistic that will actually happen. Our adjusted (for mispricing) gains figure for the next twelve months stands at +15.1%.

Our current end-of-FY '15 forecast has slipped from 5,900 at the start of June 30th 2014 – to 5,850 now. Our 'high' forecast climbed during the week to be back above 6,000. Therefore, we maintain our position held since September 2013 that 6,000 is unlikely to stick until the second half of 2015. But, unlike last week, a 6,000 breach in FY '15 has a chance in FY'15.

Market stats

Our market volatility (Chart 1) estimate is heading back to normal. Disorder (Chart 2) is normal. Our Fear Index (Chart 3) started its path back to the normal bounds but bounced back up again on Friday.

Chart 4 shows that our capital gains' forecasts have been volatile for a little while but the trend up is strengthening. This is an excellent sign for the future.

With expected yields at 4.9%, franking credits and +15.1% adjusted capital gains expected for the next 12 months, we could well be sitting pretty this time next year.

Market mispricing (Chart 5) is -5.9%. All sectors (except for Property at +0.2% and Telcos +0.7%) are underpriced. Some sectors are extremely cheap. When the fear index retreats to the normal zone, buying opportunities could present themselves – but that is a little way off for all but the brave. It's a close call (which is why I bought last week) but I bought for the long term and I can handle a bit more volatility.

The high-yield sectors' expected dividends have climbed to the high end of the 5% - 6% range but they are still moving together. The yield play has not ended yet so I am sitting tight. Indeed, the big banks are looking like a strong buy if the markets settle before they go ex-div.

Glossary

Abenomics – Japan's Prime Minister Shinzo Abe came to power early in 2013 and has brought a new economic style to managing that economy.

ASX forecasts - We have further supplemented our forecasting process for the ASX 200 by including not just a forecast of the peak (at some unspecified time during the year) but also the low. Thus, we now have an end point (e-o-y forecast) and a range for the whole year. Naturally, on a rising market the low is more likely to occur earlier in the year and the high nearer the end. Since we publish our forecasts to the nearest 50 points to reduce the sense of false accuracy a change of just a couple of points can kick the forecast over by 50 points at around the 25 and 75 marks.

Australian debt ceiling – Labor brought in a debt ceiling in mid 2008 of $75bn to self-impose some fiscal discipline during the onset of the GFC. Within seven months that ceiling was almost trebled to $200bn and it has since been raised to $300bn during Labor's term in office. Since before 2008 we had no debt ceiling that is equivalent to an infinite ceiling!!!

Black Friday – This term is used for the Friday after Thanksgiving in the US to denote the start of the shopping season for the holidays. Black refers to the accounts going back into the black from increased sales – it is certainly not a negative term!

China's shadow banking – In essence, the China government dictates what all banks must lend at and pay for deposits. As a result, if a potential borrower is deemed too risky at the prevailing rate, the banks refuse to lend (rather than increase borrowing rates as may happen here). The 'failed' borrower may then seek funding from the shadow banking system that is not so regulated.

It appears that any defaults in the shadow banking system would be covered by the Central Bank so there would not be the sort of contagion problems that arose in the US and Europe. However, a serious round of defaults in China would put a bit of a brake on growth.

FOMC – The Federal Open Market Committee determines monetary policy in the United States. It can be thought of as being similar to our Reserve Bank board.

GOP – stands for Grand Old Party which is an alternative name for the US Republican Party.

HSBC flash PMI – HSPC publishes an alternative to the official PMI for China. It is based on a survey of predominantly small to medium sized firms – unlike the official version. The number on the 1st of the month gets much less attention than the official but the preliminary, or 'flash', reading gets attention as a read a week or two before the official numbers.

High-Yield Sectors: by this, we mean Financials, Property, Telcos and Utilities.

ISM - Institute of Supply Management produces a 'PMI-like' number for the US economy. Like the PMI, 50 is the cut off between improving and worsening expectations.

Long-run mispricing – This measure is based on analysing trends over more than a century of data. The average period of over- or under-pricing is about 18 months. That is, we do not expect the market to rapidly approach its fair value.

Short-run mispricing – This exuberance measure is our mispricing statistic reported in Chart 5. It is based on 12-month-ahead forecasts of the ASX 200. Please see the notes under Chart 5.

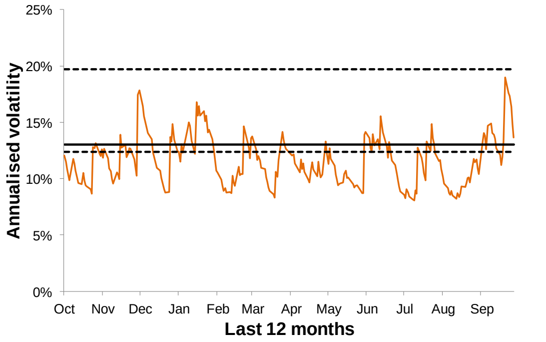
PMI – This acronym stands for Purchasing Managers Index. There is one for most countries and separate statistics for manufacturing and services. Manufacturing typically gets more attention. The statistics are published in the first few days of each month – with China on the 1st. A reading less than 50 means the sector is decreasing in its growth rate – so If China growth slows from 8% to 7%, its PMI should be below 50. If the US speeds up from 2% to 2.5%, its PMI should be above 50.

Savings ratio – In Australia, the ratio of net savings to household disposable income defines the savings ratio.

Tapering – It is the name given to the exit strategy from QE3. It is not a tightening monetary policy – just an increasingly less accommodative stimulus.

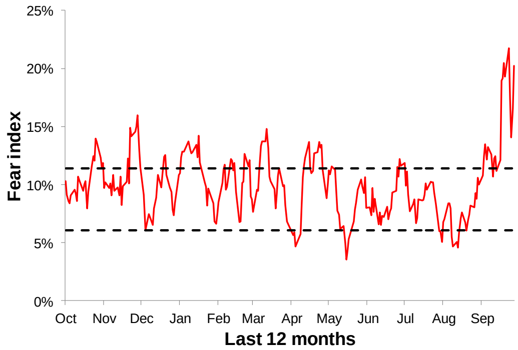
US non-farm payrolls data – are usually published on the first Friday of each month. They are generally considered to be the most reliable indicators for employment and unemployment in the US. Roughly speaking, a 200,000 increase in jobs is considered strong – particularly in the context of the tapering discussions.

Chart 1: Market volatility



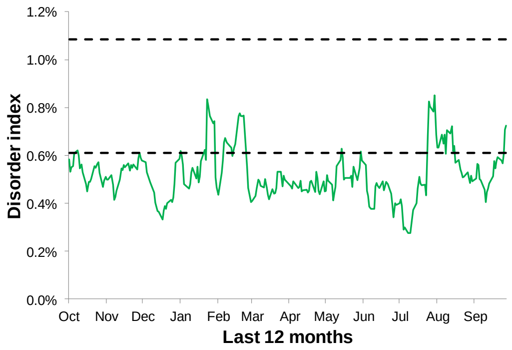
Notes: The solid black line depicts the average volatility since January 2010; the lower dotted line depicts the average volatility pre the GFC; the higher dotted line depicts the average level of volatility during the GFC - up to December 2009. The brown line is a daily estimate of the ASX 200 index volatility.

Chart 2: Fear index



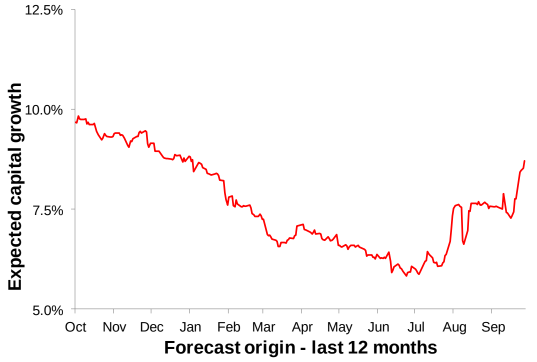
Notes: The fear index is a measure of 'excess' volatility denoting behaviour outside the open/close values each day. The two dotted lines depict the band in which the fear index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate complacency. Extended periods, or extreme values, of the index above the higher dotted line might indicate a propensity for the market to overreact in an irrational manner.

Chart 3: Disorder index



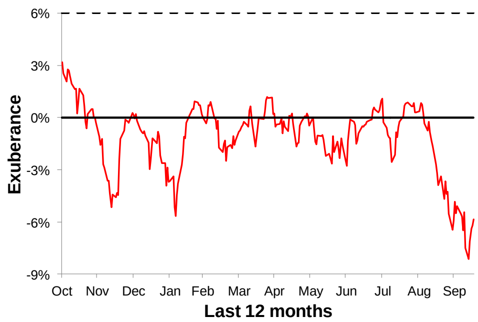
Notes: The disorder index measures the degree to which the 11 sectors' daily returns move in harmony. The two dotted lines depict the band in which the disorder index resided before the GFC in two thirds of days. Extended periods below the lower dotted line might indicate belief that there is little information to have different impacts on different sectors. Extended periods, or extreme values, of the index above the higher dotted line might indicate investors and traders are lurching from sector to sector in search of a new trend.

Chart 4: 12-month-ahead capital gains forecasts



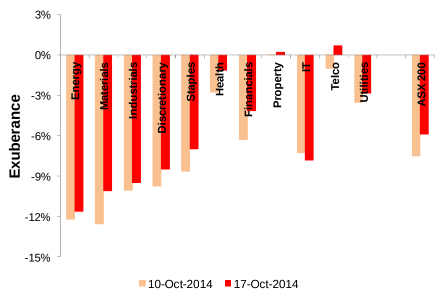
Notes: Each business day we update our estimates for capital gains on the ASX 200 for the following 12 months. For example, the left-most estimate on the vertical axis is a forecast for the 12 months concluding today. The right hand estimate is for the 12 months from today.

Chart 5: Market exuberance



Notes: Exuberance is our measure of mispricing on the ASX 200. A value below the solid black line denotes the market is perceived to be cheap and above that line expensive. Experience suggests that exuberance above +6%, denoted by the dotted line, is an indicator of a potential correction of 6% to 10% - or for the market to move sideways for an extended period.

Chart 6: Sector exuberance



Notes: The estimates in this chart are based on the same notions as for Chart 5. More detailed information on mispricing is contained in our companion weekly publication in the same section of our website